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Risky Choices: Simulating Public Pension funding Stress with Realistic Shocks.

Though they often fly under the radar in public discourse, state and local pension plans are among the most important institutions in the modern economy. They provide retirement benefits for nearly 10 million beneficiaries; have nearly 20 million members, and manage nearly $4 trillion in assets.[1] The huge scale of these plans means that seemingly obscure assumptions on investment returns and discount rates have enormous consequences.

In recent years, the risky funding system underlying these plans has come under fire in academic circles. For example, Brown and Wilcox (2009) and Rauh and Novy-Marx (2014) argue that the discount rates used by public plans to account for future liabilities are generally too high. These papers note that these liabilities, when discounted at rates closer to those offered by municipal bonds, are significantly larger and require substantially more upfront funding. Administrators of public plans have pushed back against this critique, arguing that commonly used discount rates better reflect the true historical experience and asset requirements facing plans (NASRA 2010).

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